Cooperative Reorganizations:

Advantages, Requirements, and Problems

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Many organizations formed by farmers as a means of reducing their costs of marketing were organized before the present cooperative marketing laws were passed. These companies are one by one reorganizing to become more fully cooperative. The numerous problems arising in making this change, especially for companies with capital stock like the farmers' elevators, call for analysis and suggestive comment.

I.—A group of Ohio farmers wishing to form a cooperative incorporates under Sections 10186-1-30 of the General Code (frequently called the Green-Farnsworth Act or the Cooperative Marketing Law, 1923). An association incorporating under this law, in addition to several minor provisions, agrees

1. That it will admit as members only agricultural producers, or cooperatives made up of agricultural producers.

2. That it will do no more business with non-members than it does with members.

3. That it will pay no more than 8 per cent annual dividends on its stock outstanding. (It may be set up as a membership organization without capital stock.)

4. That it will distribute its remaining earnings on a patronage basis.

II.—Federal Law. (Capper-Volstead law, 1922.) One of the purposes of cooperative legislation has been the protection of farmer groups from unfair prosecution under laws against restraint of trade.

In 1922 the Capper-Volstead law was passed, giving certain protection to associations "corporate or otherwise, with or without capital stock," "operating for the mutual benefit of the members thereof as producers." The main requirements are similar to those of the Ohio law. Later, the Internal Revenue law was amended (1926) to make such associations exempt from Federal corporation taxes; in executing the provisions of this law the Bureau of Internal Revenue has added two requirements to those above, namely,

1. That in distributing patronage dividends, non-members shall be treated the same as members, except that the dividend of the non-member may, instead of being paid to him in cash, be accumulated to his credit until sufficient to buy him a share of stock.

2. That no more than 15 per cent of the volume of business can be with those who are not agricultural producers.

III.—What is gained by meeting these requirements?

1. Protection from unfair attack under laws, Federal or State, against restraint of trade.

2. A $10 annual franchise tax takes the place of the higher franchise tax of the corporation for profit.

3. The privilege of borrowing from the Bank for Cooperatives at favorable rates and terms of payment.

4. Eligibility to exemption from Federal Corporation Income and Capital stock taxes.

5. Eligibility to membership or stockholding in a central cooperative.

6. Increased strength in its own trading territory by
   a. Addition of new members, especially the young farmers and the newcomers in the community.
   b. Expansion of its territory and volume of business.
   c. Keeping in the community, money that would otherwise go to Columbus or Washington in taxes.
   d. Making the farm organization completely democratic.
   e. Development of a better community attitude toward the organization.

Problems that may Arise in Making the Company Cooperative

I.—Too much of its volume of business is with non-members. It is assumed that the company shall continue to accept this business, in the meantime losing its eligibility. An effort should be made to get farmer-patrons, by:

1. Crediting their patronage dividends toward purchase of stock, which is issued to the patron when the purchase price has been accumulated; or

2. Getting the non-member patron to give his note for a share of stock, thus giving him the right of vote and the association the right to count his business as member business—the stock certificate in the meantime being held by the association until fully paid by patronage dividends, or cash, or the two together.

3. The manager, aided by a committee of the Board of Directors, should be actively at work seeking to get all the regular farmer-patrons of the company into membership in it—beginning with the large volume patrons first.

II.—Too many members are non-farmers. Some companies, in organizing, accepted merchants, bankers, and other villagers as members. More often, the problem has arisen through retirement of members from farming, and from inheritance of stock by heirs not engaged in farming in the company's trade territory. The Bureau of Internal Revenue allows some tolerance at this point, but certainly no more ineligibles should be accepted into membership. Effort should be exerted to reduce ineligibles to a minimum.

1. The getting in of new and eligible members decreases the percentage of ineligibles. For example, an association of 100 members with 12 ineligibles among them (12 per cent) by taking in 20 new and eligible members has now 12 ineligibles in a membership of 120 (10 per cent).

2. Active effort should be made to buy in the stock held by those not eligible, and especially from estates in which the stock is likely to go to ineligible heirs.

3. Some companies, when reorganizing, provide a limited amount of preferred stock of the same par value as the common stock. They find that some members who refuse utterly to sell their common stock are willing to accept preferred stock in its place. The preferred stock can also be issued to the non-

producer patron when his patronage dividends have earned him a share of stock, and he is not eligible to hold common stock.

4. The association should adopt a by-law which permits the calling in of stock held by ineligibles and providing for an appraised value thereof. For example, one company has the following by-law:

"In the event the Board of Directors shall find that any holder of common stock is ineligible and will continue to be ineligible to hold the same, the Board of Directors may call in such stock for redemption at the appraised value plus declared and unpaid dividends. In case of the failure of the holder to return such stock when so requested, the Board may order such stock cancelled on the books of the company, after which time such stock shall carry no rights to further dividends or to vote on any question before the company, and shall retain only the right to redemption as above provided."

Note: What can be accomplished in securing new members, if effort is really made, is illustrated by one company's expansion from 90 members to more than 200; another company added 50 new members in one year.

III.—Company has built up a surplus and stock is now so valuable that few are able or willing to buy it, and earning it by patronage dividends is too long a process. Many a company with $100 shares has surplus making the book value of the stock $200 to $400 per share.

1. It should be recognized that non-stockholder business has helped to build this surplus. Hence, stockholders should not insist on keeping for themselves all of the surplus thus far accumulated, or forcing an incoming member to pay book value for the stock.

2. A plan much used may be pictured thus: A company's $100 stock has a book value of $175. The company amends its articles of incorporation to become cooperative with shares at $25 par value. It gives each holder of stock five $25 shares for each $100 share of old stock, thus rewarding them for the risk of early days, and still leaving the company with considerable surplus. (Each $25 share would still have a book value of $35.)

3. But a stockholder says: "Why give outsiders any share of the existing surplus? Isn't it all ours?" Legally it is. Really, non-stockholder business helped to build that surplus. Many a company now financially strong would have failed long ago if it were not for non-stockholder business. The real question is, How can we best build up the business? Every company which has made any considerable progress in taking in new members has found that with this increasing membership came increased volume of business, improving financial status, and growing influence in its community. Shall the growth and policies of a farm-merchandising organization be held back by the ill feeling and jealousies of the past or even the selfishness of the present?

4. Another stockholder says, "But I had to invest $100 to get in. Why shouldn't others pay $100 to get in?" Most stockholders recognize that when these companies were formed, farmers could then invest $100 as easily as they can invest $25 now. But, if there is strong feeling on this point, and especially if more capital is needed, this plan can be followed: Accept a new member on a $25 share, give him the right to vote, and the company secures the right to count his business as member business; require him, however, to allow his patronage dividends applied to purchasing more shares until he has $50, $75, or $100 of stock as seems best to require.

IV.—We have a big village coal trade, and more than 15 per cent of our business is with non-farmers. What makes this problem more difficult is that the grain volume and the merchandise volume are figured separately, and not to exceed 15 per cent of the merchandise business can be with non-farmers. Thus is created a real problem for which some companies can find a solution only through a long campaign, and possibly not then.

Any villagers who own or operate farms and receive any agricultural products as part of the return from the farm are eligible to be counted as farmers. If the percentage of non-farm business is only a little high, say 16 to 18 per cent instead of 15 per cent or less, an active campaign to get in more farm members may solve the problem. Another contribution would be to handle more items of the types bought by farmers, such as fence, posts, farm tools, seeds, sprays, insecticides. It is possible, also, that a subsidiary company could be organized to handle this non-farmer business. Such a corporation would be a profit corporation and would pay State and Federal taxes as such, but such taxes on the limited net worth and income would be small, and the parent company could be fully cooperative and exempt.

V.—If we continue giving stock in patronage dividends, we shall get too much stock outstanding.

No, or certainly not necessarily.

1. Effort should be continuous to get in stock from members retiring from farming, moving away, or deceased. One manager tells me he bought in 20 shares of stock from two retired farmers, and thus had a share each for 20 new members, with no added stock outstanding.

2. The issuance of a $25 share to each of 60 new members will add only $1,500 to stock outstanding. If you require $50 from each, $3,000 of stock would be added. But, the added business would far more than pay the dividend of, say, 6 per cent on this stock, $90 in the one case, and $180 in the other.

3. Aside from these shares to new members, these general principles may help in solving the question:

a. In declaring a dividend, the Board has full right to determine whether it shall be paid in cash, in trade, in stock, or in credit on account. It is a growing practice that any dividend be applied first to any debt owed by the recipient to the company (except in case of the non-member patron whom the company desires to get into membership).

b. Whether the dividend shall be in stock or in cash, depends on the financial situation of the company. If the company owes on no notes and mortgages, and will, after paying the dividend, still have ample working capital, pay the dividend in cash.

c. The actual payment of a dividend declared and allocated to the member or patron may be deferred for a year or more (in case of dividend on the stock, not more than six months).

d. If the company is not fully financed, as is shown by considerable debt outstanding, then use the earnings to pay debts, and issue the dividends in the form of stock or credits toward the purchase of stock.

For example, suppose that a company makes net earnings which after paying a fair dividend on the stock leaves $7,200 to distribute in patronage dividends, and the board decides to pay a patronage dividend of 3 per cent on the $240,000 of business. Assume further that $168,000 of this business is with stockholders, and $72,000 with non-stockholders. What happens?

(1) The 3 per cent on the $72,000 of non-stockholder business, which would be $2,160, is credited to them toward the purchase of stock, so would not require the paying out of money.*

(2) Some of the stockholders owe the company on account. Their patronage dividends can be credited on their accounts, which in different companies would absorb from a few dollars of the dividends up possibly to $4,000 or more. Let us assume in the present illustration that $2,500 is thus credited to account.

(3) These two factors in the distribution have taken $2,500 plus $2,160, or $4,660, and leave for further distribution to the stockholders only $2,540* of the $7,200. If the company is in a strong cash position, it will probably pay this $2,540 in cash. If, on the other hand, it is in debt or in need of more working capital, it will keep the cash and issue to the patrons stock or credits toward the purchase of stock.

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* Note that some of these non-stockholders would possibly have total credits in excess of the purchase price of a share of stock, and this might require a small amount of cash or credit on account in addition to the $2,540.

A Board of Directors may also adopt a policy of requiring those who have, for example, one $25 share to apply all patronage dividends to purchase of more stock until the holder has $50, $75, or $100 as the company's needs require.

Note: Pay dividend on the stock itself in cash or credit on account; this is what will make the stock worth owning—will prove to the holder that he is getting something more than "some more paper."

VI.—Distribution of Earnings. It is assumed that after the determination of gross earnings, all operating outlays are deducted; proper reserves are set up for depreciation of plant and equipment, and for losses on uncollectable accounts, if any; interest accrued during the period is deducted; and the dividend on the stock is next determined. "All other income, less specified reserves which shall be provided in the by-laws, shall be distributed on the basis of patronage" are the words of the Ohio law. But there are several degrees of completeness in this distribution.

1. In case the association is applying for exemption from income tax, it must "treat non-members the same as it treats members in the distribution of patronage dividends," and that means village patrons as well as farmer patrons. The following by-law is suggested as suitable in such a case, the first paragraph to be followed by (a) in case the association has preferred stock of the same par value as the common, or by (b) in case the association has only common stock.

"Patronage refunds shall be apportioned among all the patrons of the association in proportion to their respective patronage with the association. In case of a patron who is not a holder of common stock in this association, the patronage dividend shall, instead of being paid to him, be set up to his credit until the amount of his credit shall equal the price at which the association is selling its treasury stock or its unissued shares, at which time in case he is eligible for membership in the association, a certificate for a share of stock shall be issued to him."

(a) "In case the patron is not eligible to hold the common stock of this association, instead of a share of common stock he shall receive a share of preferred stock, after which he shall be treated in the distribution of patronage dividends as if he were a holder of common stock."

(b) "In case the patron is not eligible to hold the common stock of this association, an amount of his accumulated patronage dividends equal to the price of a share of stock shall be held as a deposit in the patron's name, after which he shall be treated in the distribution of dividends as if he were a stockholder. This deposit to his credit shall be payable to him on his removal from the territory or to his estate in the event of his death. He shall receive each year as interest on his deposit the same amount as the dividend of that year on a share of stock."

2. The association may for some reason decide to ignore the village trade in its distribution of patronage dividends, but, in the effort to get all the farmers in its territory affiliated with it, realize that it can use patronage dividends to that end. In such a situation the following by-law would be suitable:

"The percentage of the total business of the association which was done by agricultural producers shall be determined. This percentage of the earnings remaining after the distribution provided above shall be allocated among all producer patrons in proportion to their respective volumes of trade with the association. To stockholders, this amount allocated shall be paid in cash, trade, or stock as determined by the Board of Directors. To the producer not a stockholder, the amount allocated shall be set up as a credit toward the purchase of a share of stock; when the total of his credits so allocated reaches the price of a share of stock, a certificate shall be issued to him."

3. Many associations pay patronage dividends to stockholders only. They may or may not encourage farmer patrons to join them by allowing a farmer to secure a share of stock by giving the association his promissory note for it, but no dividends are paid to any but stockholders. In such a situation, the following by-law is suitable:

"The percentage which the stockholders have furnished of the total volume of buiness shall be determined. This percentage of the net earnings remaining after the distribution provided above shall be apportioned among the stockholders in proportion to the respective amounts of business furnished by each, such patronage dividend to be distributed in cash, trade, credit on account, or such other form as may be determined by the Board of Directors."

As pointed out above, the practice described in No. 1 is the only one that warrants an application for exemption from corporation income tax. In case of the practices described in Nos. 2 and 3, it has for years been the practice of the Internal Revenue examiners to allow the deduction from "taxable income" of all patronage dividends so paid.

VII.—The Revolving Fund Method of Financing a Cooperative. The carrying out of the above suggestions regarding the use of patronage dividends to bring non-member farmers into membership, the purchase of stock of those no longer in position to trade with the company, the work of an active committee in securing new farmer members, will go far toward building up and maintaining a live membership. It still may happen, however, that member A has five to ten times the investment in the organization which member B has, while B deals several times as much with the organization as A. Many organizations regard this as undemocratic and unfair. No method can bring it about that each one's financing of the organization and his use of it are in exactly the same ratio. The "Revolving Fund Method" is used to approximate this ideal as nearly as may be.

We have pointed out above that, in general, in Ohio an association continues to issue patronage dividends to farmer stockholders only so long as its debt and cash position requires it. After its debts are paid and sufficient cash balance accumulated, patronage dividends are paid in cash or credit on account. Under the Revolving Capital method, patronage dividends continue indefinitely to be paid in new stock, the cash thus retained being used year after year, to retire the oldest outstanding stock.

Thus, the relative ownership by the members is continually shifted by the issue of new stock in proportion to the last year's business of each patron and retirement of stock based on original investment or trade of earlier years. When this plan is fully in operation, the stock of the company, that is, the investment in it by its members, will be in proportion to the business of those members with it over the period of recent years.

To simplify the explanation, we have used the term "stock" throughout. Many associations have no stock. Aside from a membership fee, the financial interest of the members is represented by some form of certificates of indebtedness. In such a case, substitute the term "certificate of indebtedness" for the term "stock" in the above discussion.

Another thing to note is that either stock or certificates of indebtedness may be issued for capital deductions as well as for cash or patronage dividends. In many companies, especially in those companies which do not determine the price to the producer until after selling the product (for example, creamery, cheese, milk, livestock), the association makes a deduction not only for operating expense but also for capital investment, say, ½ cent per pound or 1 cent per hundredweight, for which at the end of the period the patron receives stock or certificates of indebtedness. These certificates of stock or indebtedness can be rotated or revolved as described above.

VIII.—Generally in case of a reorganization, it is necessary to call in the old stock and issue new. Care should be used in preparing the material to go on these new certificates.

A. What Should Go on the Common Stock Certificate?

1. Face of the certificate:

   a. In addition to the form which any printer of stock certificates can furnish, there should be a clause prohibiting "the transfer of the common stock of the association to persons not engaged in the production of agricultural products handled by the association." This clause is required by law.

   b. Many companies also add the following clause: "A lien is reserved upon this stock for any claims held by the association against the holder of record."

2. Back of the certificate:

   a. All sections of the Articles of Incorporation or By-Laws covering the rights of the holder of the stock. These would include—

      Any section limiting the right to vote.

      Any section limiting the right of transfer of the stock.

      Any section requiring the holder to surrender the certificate of stock on demand of the association, and defining the conditions warranting such demand.

   b. Some companies also enter here the clause from the law or the by-laws limiting the amount of stock one stockholder may hold.

   c. If the company also issues preferred stock, a copy of the sections in the Articles providing the preferences and restrictions applying to the preferred stock.

B. What Should Appear on the Preferred Stock Certificate?

1. On the face, the ordinary form to be furnished by any printer, and in fine print below the certificate proper and above the signature, a reference to the sections on the back of the certificate as part of it.
2. On the back, all the provisions from the Articles of Incorporation relating to the Preferred Stock.

And finally, if and when you secure exemption, *live up to requirements.*

C. In gaining exemption, you certify to facts showing that you are meeting requirements; you further agree to notify the Revenue officials if you at any time change your plan of operation regarding any of the requirements.

You must constantly be alert—

1. To keep your membership made up mainly of agricultural producers; to that end, take in no more non-producers, continue getting in more farmer members, and adopt some plan of buying in stock of stockholders who are not farmers or not so situated as to be patrons.
2. Treat non-members just as you treat members in allocation of patronage dividends. Furthermore, a paper allocation of dividends which the patron never gets on retiring from farming, or on removing from the territory, or which his estate does not receive, is not "treating non-members the same as members" and should not be acceptable to any examiner or court.
3. Normally allocate practically all your earnings for each year; the actual distribution may be made in cash, in trade, or in stock and may be postponed for a time—perhaps one or several years, depending on whether it is regarded as "reasonable" by any examiner or court. If you are setting up a reserve for any purpose, make that purpose as specific as possible, and let the reserve set up be "reasonable" for the purpose in mind; it may help to have a resolution on your Board minutes providing for the reserve. Leaving a large part of your earnings in surplus with no reason assigned, is not likely to be regarded as "setting up a reserve" for a specific purpose.

Note: Several Boards have this year set up an allocation of dividends, which leaves approximately half their earnings in "surplus." I hope they never have tax and penalties to pay, but I certainly shall not be surprised if they do. One company secured exemption, did as it pleased from then on, and 13 years later paid $28,000 in back taxes, penalties, and interest. I would like to see such cases, if any continue to be outside of Ohio.

Another point worthy of note: Some associations follow a practice recommended by some auditors and others interested in cooperatives, which is to file a tax return even if exemption has been secured. This practice has two advantages: the company which files a return every year will probably examine that return each time to make sure that it is entitled to exemption; also the filing of a return limits the period (at present, to three years) over which the examiner can later go back to determine taxes and penalties. None of us want to be assessed $28,000 at once as was the Maryland Company above mentioned.

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